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SUBJECT: ETHIOPIA MONTHLY ECONOMIC REVIEW FOR AUGUST 2007

#### ¶1. SUMMARY

--Council of ministers approved salary increase for civil servants;

--The consumer price index still on the rise; CPI inflation reached 18% in August; Government action to curb price hike; minister asks to expose speculators;

--The official exchange rate of the Ethiopian Birr against the US\$ continued to slowly depreciate; Birr 9.0359/US\$ at the end of August;

--Ethiopia received \$2.6 billion loans and aid from external sources during the 2006/07 Ethiopian fiscal year, which ended July 7, 2007;

--Investment in the mining and energy sector is flourishing; 14 foreign firms are granted license;

--Ethiopian Airlines secured a loan for the purchase of 10 B787 Dreamliner aircrafts. End Summary

#### BUDGET/FINANCE

¶2. Finance Minister Sufian Ahmed announced on September 1 that the Ethiopian Government (GoE) approved a significant salary increase for civil servants effective July 8, 2007. According to the Minister, the decision stemmed from a study conducted over the last few months by a task force composed of experts from his ministry and the Civil Service Commission on how to abate the effects of rising inflation on civil servants. Although the decision will cost the GoE an estimated \$200 million per annum, the Minister argued that the increment would not have significant fiscal impact as the FY 2007/08 budget was prepared with a salary adjustment in mind. The salary increment ranges from 17.5 to 36.2 percent based on different wage grades with employees from high and low salary brackets receiving the greatest percentage increase. The move increases the minimum wage by 36.2%, from \$26 to \$35 per month. The minimum pension is also increased by 60 percent from \$11 to \$17.7. In a recent discussion with Ethiopian youth, Prime Minister Meles also indicated that similar salary adjustments will be made to state enterprises, major employers in Ethiopia.

¶3. Despite increasing pressure from opposition parties, the GoE has been hesitant to introduce a salary adjustment arguing that the source of inflation was not fully understood. While local analysts differ on the likely impact of the increase on inflation, most see no fiscal impact on the state. Many see it as a nominal wage increase rather than a real wage improvement that should come as a result of the continuous structural transformation of the economy. Some view the current salary adjustment exacerbating the existing inflation, due to businesses speculating on prices. The Central Statistics Agency (CSA) announced that the Consumer Price Index (CPI) as of July stood at 18 percent on an annualized rate in contrast to 12.3 percent last year. Analysts recommend the government to pursue its reform agenda in liberalizing and transforming the structure of the economy in the areas of finance;

telecommunications and expansion of the tax base from the current coverage of 13 percent of GDP to at least the African average of 29 percent.

#### INFLATION AND PRICE DEVELOPMENTS

¶4. According to official statistics published by CSA, the annualized average country level headline inflation rate reached 18 percent in July 2007 in contrast to 17.8 percent in June, 17.3 percent in May and 12.3 percent a year earlier. In a bid to curb the persistently rising inflation the government has: begun distributing subsidized wheat in Addis Ababa since February 2007; lifted the surtax on imported edible oil; increased monitoring of hoarding by speculative businesses; banned the export of selected foodstuffs; and raised the minimum bank deposit rate and commercial banks' reserve requirement ratio. State Minister of Trade and Industry, Ahmed Tusa, defended the GoE's efforts in combating inflation, arguing that inflation is a routine phenomenon in any economy caused by a variety of market forces and suggesting that much of the price hikes have been caused by lack of strong consumer groups in Ethiopia.

¶5. Nonetheless, some economists predict that inflation may continue to rise until the main harvest begins in October. The recent increases in salaries coupled with the Millennium celebration have already triggered increases in the prices of consumer goods.

#### EXCHANGE RATE

¶6. The National Bank of Ethiopia (NBE) claims that the official exchange rate of the Ethiopian Birr is determined by the daily inter-bank foreign exchange market in which NBE (central bank) intervenes to regulate the market. The inter-bank rate at the end of August reached Birr 9.0359 per US dollar in contrast to Birr 9.0326 at end July 2007 and Birr 8.6998 a year earlier. Meanwhile, the Birr depreciated in the parallel market to Birr 9.32 from Birr

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9.25 last month. The parallel market rate is expected to appreciate in favor of the Birr in September as more remittances are expected to flow into Ethiopia for the Ethiopian Millennium celebrations. Driven by rising domestic inflation relative to prices of Ethiopia's major trading partners, the real effective exchange rate is appreciating, making the country's exports less competitive.

#### INTEREST RATE DEVELOPMENT

¶7. The central bank liberalized the lending interest rate of banks, allowing it to be determined by market forces for the first time since January 1998. The central bank continues to control the floor bank deposit rate. The minimum deposit rate which was fixed at 3 percent per annum since March 2002 was revised to be 4 percent effective July 4, 2007. Consequently, commercial banks have revised their interest rate structure; minimum and maximum lending rates revised upwards by one percentage point to 8 percent and 15 percent per annum, respectively. Considering the double digit inflation rate of 18 percent, real interest rates on treasury bills, inter-bank money market, bank deposits and lending are significantly negative, implying depositors are subsidizing borrowers that encourage monetary expansion and fueling inflation.

#### EXTERNAL DEBT

¶8. Ethiopia benefited from a total of US\$2.6 billion in foreign loans and aid during the just concluded Ethiopian budget year. According to the Ministry of Finance and Economic Development, \$1.8 billion of this came in aid while the balance came from loans. While \$2.3 billion loans and aid were obtained from multilateral sources the remaining \$300 million came from development partner governments. Britain, Sweden, Canada, Ireland, France, Germany, Japan, China, the Netherlands, the USA and Finland were among the development partners who extended aid to Ethiopia during the reported period. Roughly 80 percent of the aid came from Britain, Sweden, Canada, and France. Most of the external resources are designated for the implementation of agriculture, electrification, health, education, road construction, clean water, food security and disaster prevention, capacity building, and telecommunications

projects. Ethiopia has also benefited from HIPC and the Multilateral Debt Relief Initiative (MDRI) approved by G8 countries. Some \$200 million debt was cancelled through HIPC and MDRI initiatives during the year.

## ENERGY

¶9. Investments in the petroleum and mining sectors have flourished in Ethiopia in recent periods. Some 66 mineral operational and exploration licenses have been issued by the Ministry of Mines and Energy. Licenses were granted to 42 private companies engaged in large-scale mining operations, 14 of which are foreign, 21 are joint ventures, and seven local. Petroleum exploration is currently underway in the Gambella and Ogaden regions as well as in the Southern Rift and Abay Basins. Malaysia's Petronas, Holland's Pexco, Sweden's Lundin, and China's Zhongyuan Petroleum Exploration Bureau are among the major foreign companies involved in Ethiopia's petroleum exploration and development. According to the Ministry, roughly 40 percent of the country has already been geologically mapped for mineral exploration and hydrology geophysics.

¶10. Fuel imports represent a significant drain on Ethiopia's scarce hard currency reserves. A decade ago, Ethiopia's expenditure on fuel was a mere \$166 million; in fiscal year 2006/07 the country imported 1.8 million tons of petroleum products valued at \$885 million. According to the Ethiopian Petroleum Enterprise (EPE), Ethiopia's petroleum demand for 2007/08 fiscal year is estimated at \$1.2 billion.

¶11. The escalating cost of petroleum in the global market has prompted the GoE to look for alternative energy resources, especially bio-fuel. The Council of Ministers approved a bio-fuel development and utilization strategy this year. The strategy provides for the development and use of bio-fuel extracted from plants in ways that do not tamper with food security efforts and that do not contravene the interests of farmers and pastoralists. The strategy also provides for export of such bio-fuel products. Alemayehu Tegenu, Minister of Mines and Energy, said that fuel stations in Addis Ababa will start to sell 95 percent benzene/ five percent ethanol blended fuel by October 2007, and would increase the ethanol portion to 10 percent in the future.

## AVIATION

¶12. Since its beginnings in 1946, Ethiopian Airlines (EAL) today serves 50 destinations across the globe -- 28 of them in Africa -- with annual passenger traffic of over 1.5 million. At present Ethiopian owns 28 commercial aircraft and has ordered ten Boeing 787 Dreamliner aircrafts -- the first two of which are scheduled for delivery in October 2008. Kassim Geresu, Executive VP for Finance and Planning, said that EAL had selected an ING and DVB consortium to finance the purchase over a proposal by a Citibank, Barclays, and Natexis consortium's offer. The management of the airline and the banks are expected to sign an agreement in the near future. The ten

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B787 aircraft are valued at \$1.3 billion. General Electric will supply 20 engines which will power the ten B787s. The total value of the engines is \$300 million. The US ExIm Bank had agreed to provide a bank guarantee for 85 percent of the loan required for the aircraft purchase.

¶13. In fiscal year 2006/07 ending June 2007, EAL generated \$763 million revenue, a 28 percent increase compared to that of last year. Its operating expense has increased by 30 percent to \$741 million. The airline transported 2.1 million passengers, a 19 percent annual increase. In the current fiscal year (2007/08) Ethiopian plans to increase its operating revenue by 18.6 percent to \$900 million. The airline is facing stiff competition from foreign carriers, especially Middle Eastern carriers such as Emirates and Qatar.

Yamamoto